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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1961

No. 657

KENTUCKY HOME MUTUAL LIFE INSURANCE COMPANY, - - - Petitioner,

versus

UNITED STATES OF AMERICA, - - Respondent.

REPLY BRIEF IN SUPPORT OF PETITION FOR CERTIORARI.

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The respondent's Memorandum in Opposition calls for a short reply.

First: The respondent is incorrect in attributing to us the view that the Court of Appeals erred in "ignoring" the substance of the transaction. We say rather that the Court's two opinions clearly and affirmatively show that it has wholly *misconceived* the substance of the transaction. What it has *ignored* is the special statutory definition of life insurance company income.

Second: The two cases cited by respondent, if pertinent at all, support our position rather than respondent's. In *Kentucky Home Life Insurance Co. v.*

Leisman, 268 Ky. 825, 105 S. W. 2d 1046 (1937), and in *Carrington* v. *Kentucky Home Mutual Life Insurance Co.*, 61 F. Supp. 424 (W. D. Ky., 1945), the question was whether the 1932 reinsurance agreement (and, in the latter case, the 1939 amendment) were effective, as between the company and its policyholders, in limiting Kentucky's *reinsurance* obligation to an amount less than the *original* obligation of Inter-Southern. In both cases an affirmative answer was given, the court making very plain the difference between the two separate obligations. In the *Leisman* case the Court specifically pointed out (105 S. W. 2d at p. 1048):

> "This argument [of appellee] ignores the fact that the policy was amended by the reinsurance agreement, and the liability of the appellant must be predicated on what it assumed to do under its contract. Appellee is not seeking to hold the Inter-Southern Life Insurance Company on the policy, but to hold its reinsurer. Casteel v. Kentucky Home Life Insurance Company, 258 Ky. 304, 79 S. W. 2d 941."

In neither case did the Court characterize the annual adjustments of policy impairment as interest—much less as interest subject to taxation as life insurance company income. The Kentucky Court of Appeals analogized the so-called lien to "a charge or loan against all of the policies" (105 S. W. 2d at p. 1048) in explaining that the amounts due to the beneficiaries of Inter-Southern policies were *the same as if* the policyholders had made 60% policy loans on June 30, 1932—a proposition which has nothing to do with the

present case. But this is a far cry from saying that policy loans *were* made, or that the income tax consequences are the same as if they *had been* made.

Third: We had thought it unnecessary, in view of the settled rule that the incidence of income taxes depends not on the parties' verbal characterization but on the substance of their transaction (Petition for Certiorari, pp. 20-24), to explain why the reinsurance agreement used the terms "lien" and "interest" in a technically inaccurate manner. But the respondent's failure to respond to our claim that the annual adjustments were not "interest"—except to labor the obvious fact that (for reasons explained at pages 6-7 of the Petition for Certiorari) the *amounts* of the adjustments increased year by year—suggests that it is appropriate to show how the terms "lien" and "interest" came to be used in the reinsurance agreement. A few pages of history (which, as usual, are worth volumes of logic) will suffice to show that the use of these terms in the agreement cannot possibly be regarded as a conscious recognition or concession that "interest" adjustments or payments would constitute interest income within the meaning of the Internal Revenue Code.

The general pattern of the 1932 reinsurance agreement, which established the basic legal relationships here involved, was simple enough. Kentucky, then newly organized, agreed to take over Inter-Southern's assets and to assume Inter-Southern's liabilities, including obligations on its outstanding policies, *to the*

extent that it could expect to carry them by use of assets thus received.

However, because of the complexities of the insurance business and the diverse provisions of Inter-Southern's several types of policies, a detailed and complex contract was needed to implement this simple objective. Still further complexity was occasioned by the uncertainty of the parties as to how much Inter-Southern's assets would ultimately prove to be worth, and the additional uncertainty—implicit in any insurance business—as to how much the claims on policies would eventually turn out to be.

These problems were met in the following manner: Estimated valuations were arbitrarily assigned to the Inter-Southern assets. On the basis of these valuations, and on assumptions as to its liabilities, the impairment of the equity of its existing policyholders was tentatively estimated at 60% of the reserve on their respective policies as of June 30, 1932. On each Inter-Southern policy Kentucky therefore tentatively limited its reinsurance obligation, so far as policy loans and pre-death cash settlements were concerned, to the amounts guaranteed by Inter-Southern *less 60% of the reserve on the respective policy as of June 30, 1932*—except that this 60% reduction was not at that time made applicable to death claims (Pars. 4 and 5) (R. 15-17; App'x 11a-13a).

In recognition of the possibility that the assumption as to the value of Inter-Southern's net assets might prove to be too high, provision was made for

subsequent increase of the 60% figure in the light of later experience (Pars. 15, 16, 18, 28) (R. 24-27, 31-32; App'x 20a-22a, 27a-28a). And in order that the Inter-Southern policyholders rather than Kentucky might get the benefit of any profit which might result from favorable developments with respect to the value of Inter-Southern's assets or the mortality experience under its policies, Kentucky agreed to keep its accounts on the reinsured business separate from its accounts on new business of its own, and to apply any profits on the Inter-Southern business for a period of about twenty years—specifically, until the end of 1952—to reduce the 60% impairment of the Inter-Southern policies (Pars. 19-25) (R. 27-30; App'x 23a-26a).

In substance, the 1932 reinsurance agreement thus established an arrangement much resembling an extra-judicial receivership for Inter-Southern's assets and business, whereby Kentucky would administer its affairs—receiving no profit thereon until the end of 1952 or until the Inter-Southern policies had been restored to full value, whichever should be earlier.*

In order to give practical effect to these provisions, in terms which could be understood not only by the contracting parties but by the thousands of policy-

*It will be noted that under these circumstances it made little if any difference to Kentucky whether the Inter-Southern assets were more than sufficient to carry its policy obligations, reduced as described above. If the arbitrary asset valuations proved to be too low, or if mortality experience was unexpectedly favorable, or if other unexpected gains resulted from the old Inter-Southern policies, the resulting profit would not benefit Kentucky but would be applied to reduce the 60% impairment of the policies (Par. 20) (R. 27; App'x 23a).

holders whose rights against Inter-Southern were to receive less than full recognition, it was appropriate and indeed necessary to couch the agreement—complex at best—in language as simple and familiar as possible. It was also highly desirable to utilize concepts sufficiently in keeping with the mass accounting methods necessarily used in insurance operations, so that the accounts of Inter-Southern policyholders *vis-a-vis* Kentucky could be simplified as much as possible and integrated with Kentucky's over-all accounting system, covering its own future policies as well as the reinsured Inter-Southern policies. For that reason the reinsurance agreement described the 60% burden on Inter-Southern policies as a *lien*, thereby analogizing it to the familiar concept of a policy loan. In effect, each Inter-Southern policyholder was told that his policy was impaired to the same extent as if he had borrowed, on August 8, 1932, 60% of its June 30, 1932 cash value.

A reading of the reinsurance agreement makes it perfectly clear that no lien, properly so called, was created. The relationship of the policyholder with Inter-Southern and with Kentucky was a contractual relationship. As between the parties, Kentucky had only the duty (conditioned on receipt of stated premium payments from the policyholder) to lend or pay him certain stipulated amounts upon the happening of stipulated events. The insurer's said obligation was wholly unsecured (except to the extent of statutory deposits made with the Insurance Department, which have no bearing on the present discussion).

As stated by Judge O'Sullivan below (R. 148):

> "A lien is a charge or encumbrance upon property *to secure the payment or performance of a debt,* duty, or other obligation. *United States* v. *Phillips,* 267 F. 2d 374, 377 (C. A. 5, 1959)." (Emphasis added.)

The existence or non-existence of a lien has no effect on the position of debtor and creditor *inter sese;* its only effect is to give the creditor a preferred position as against other creditors. But the so-called "lien" provided by the 1932 reinsurance agreement did not do this. Its only effect was to provide the measure of Kentucky's reinsurance obligation to Inter-Southern policyholders.

As a matter of fact, the term "lien", as used in the reinsurance agreement, was a solecism on its face: for a lien is nothing but a security device ancillary to a principal obligation. No one can sue on a lien as such, where a principal obligation does not exist. And there was no such principal obligation on the part of the Inter-Southern policyholders. They were not *indebted* to Kentucky for their share of the 60% impairment; their policies were non-assessable.

By applying the term "lien" to the 60% policy impairment, and thereby analogizing it to a policy loan, the 1932 reinsurance agreement not only made it understandable to policyholders and manageable by bookkeepers; it also automatically accomplished a further business purpose which, though less important, was nevertheless of material value both to the policy-

holders and to Kentucky: *The policyholder was in effect told that he could restore his policy to its face value by paying off the "lien" in cash.* He was thus enabled to get from Kentucky what he had originally bargained to receive from Inter-Southern, by paying his pro-rata part of Inter-Southern's impairment.

From Kentucky's viewpoint, such cash payments were of course welcome; for the 1932 reinsurance agreement clearly and repeatedly reflects the cash stringency which faced Kentucky at this incipient stage—the rights of Inter-Southern policyholders to demand cash being postponed for periods ranging from four months to three years, depending on the nature of their claims (Pars. 7, 9, 10, 11) (R. 18-22; App'x 14a-18a).

Moreover, it must be kept in mind that a policy reserve is not a static thing. It must grow with the policy. Ordinarily the means of growth is provided by investment income from the reserve assets. But where, as here, 60% of the reserve is represented by a book entry only, other provision for the necessary increase must be made. Otherwise the reserve would automatically become inadequate as the policies grew older and the reserve requirements increased.

These problems were met by means of a provision that, unless the "liens" were discharged by a cash payment, they would increase by 6% a year, compounded annually. In this way provision was made for continued adequacy of the depleted reserve assets; policyholders were given a mild incentive to put in Kentucky's hands cash which it sorely needed; and policy-

holders who elected not to do so were mildly penalized by annual reduction of the cash and loan value of their policies—a reduction which, in itself, tended to mitigate Kentucky's cash problem.

The same considerations of comprehensibility and accounting convenience as had led to the use of the term "lien" likewise suggested that the annual increase in unpaid "liens" be called "interest." Of course the increase was not actually interest; for, as Judge O'Sullivan has at least verbally recognized in his opinion below (R. 149):

> "Interest has been defined as 'the compensation allowed by law, or fixed by the parties, for the use, detention, or forbearance of money or its equivalent.' 30 Am. Jur., Interest, Sec. 2."

Payments or adjustments in Kentucky's favor by reason of the "interest" adjustments would not represent compensation for the use, detention or forbearance of money; for Kentucky had not lent the policyholder anything, and the policyholder owed Kentucky no debt on which forbearance could be granted. All Kentucky had done was to stipulate for an annual increase in the "lien" unless and until it were either paid off, or offset in a pre-death settlement, or written off in a death settlement.

As of August 8, 1932, the parties can hardly be criticized for using the terms "lien" and "interest". The terms served their business purposes well. The policyholders were thereby informed of their legal position in understandable language, and Kentucky

was enabled to handle its bookkeeping on a manageable basis. No deceit was practiced, and no advantage gained.

Actually, it is hard to devise any simple terms which, from the viewpoint of business realities, will describe the policy impairment and its annual adjustment as well as the terms actually used. Proof of this can be drawn from our own certiorari petition. For in order to keep the legal issues unclouded we there avoided use of the controversial terms wherever possible; and the Court must have noted the awkwardness of expression which necessarily resulted.

Kentucky could hardly have anticipated that, nearly a quarter of a century after 1932, a future generation of tax gatherers would appear with their magnifying lenses, their dictionaries and their blinders, and belabor Kentucky's departures from their own standards of literary purism.* It cannot be said that the use of the terms "lien" and "interest" involved any conscious acknowledgment that the "interest" payments and credits would be taxable, or that the characterizations employed in the reinsurance agreement were expected to have any more effect on the incidence of income tax than they had on the business relations involved.

The 1935 and 1939 amendments to the 1932 reinsurance agreement did not change the character of the "lien" and "interest" originally provided for. On March 16, 1935, the agreement was revised in a number of respects, the main changes being designed (a) to

*Despite full disclosure by Kentucky in each year, the present question was not raised until the 1952 return was audited in 1954.

take account of the fact that Kentucky was becoming a mutual company; (b) to eliminate the provision for separate accounts on the old Inter-Southern policies; and (c) to leave it to Kentucky to decide whether profits on the Inter-Southern business would be applied to reduce the "liens". The judicial receivership was terminated at that time.

The agreement was further revised on September 18, 1939. The only change relating to "lien" and "interest" was that the "interest" rate was reduced to 5% and the "lien" was made applicable to death claims as well as to loans and pre-death cash settlements.

The record does not disclose in detail the business considerations which led to the two revisions of the original agreement. It can fairly be inferred from the instruments themselves, however, that the changes reflected developments in Kentucky's business position, and embodied the results of negotiations in which the Insurance Commissioner was performing his official duty to protect the interests of the Inter-Southern policyholders by seeking changes mutually advantageous to them and to Kentucky.*

Each revision carried forward the terms "lien" and "interest" with the same meaning and contractual effect as in the 1932 agreement. Indeed, it could hardly

*The circumstances which led to the two amendments are recited in *Kentucky Home Mutual Life Insurance Co.* v. *Leitner*, 302 Ky. 789, 196 S. W. 2d 421 (1946), where it is noted that the necessity of charging the "lien" against death claims from and after September 18, 1939, resulted from the worthlessness of an Inter-Southern asset which, in 1932, had been valued at $2,200,750.

have been otherwise; for the business objectives which had led to use of those embattled terms by the parties to the 1932 reinsurance agreement were still important in 1935 and 1939.

We submit that the legal character of the "interest" payments and deductions here involved was initially fixed by the 1932 reinsurance agreement; that nothing in the later amendments can rightly be thought to have altered their character; and that the taxpayer is entitled to have its rights determined in accordance with the substance of its business arrangements, thus revealed, rather than on superficial verbal grounds.

When the shoe is on the other foot, the tax authorities are quick enough to treat as interest any payment received for the use of money, no matter what it is called. See, in addition to cases already cited, *Equitable Life Assurance Society* v. *United States*, 181 F. Supp. 241 (Ct. Cl., 1960; opinion by Reed, J., Ret.), cert. denied 364 U. S. 829 (1960) (loan prepayment penalties *held* taxable as interest). There is no room for a double standard.

In closing, we point out that respondent has evidently failed to grasp the meaning of our contention that the payments and adjustments in question not only did not constitute *interest*, in the accepted meaning of the term; not only did not constitute *life insurance company income* within the carefully limited definition prescribed by §201(*c*)(1) of the Internal Revenue Code of 1939; but would not even have been taxable as income pursuant to the "economic benefit" test which has been developed under §22(a), defining

"income" for taxpayers other than life insurance companies. As shown by our petition for certiorari (pp. 12-14), it is inconceivable that Kentucky realized any economic benefit in the settlement of Inter-Southern policies by deducting the so-called lien and accumulated interest, since that is the exact formula prescribed by the reinsurance agreement for determining Kentucky's liability under that instrument.

For the foregoing reasons, and for the reasons stated in the petition, certiorari should be granted.

Respectfully submitted,

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